No. 89-593

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In The

Supreme Court of the United States

October Term, 1989

LIBERTY MUTUAL INSURANCE COMPANY, and
LIBERTY MUTUAL FIRE INSURANCE COMPANY,

Petitioners,

v.

COMMISSIONER OF REVENUE,
COMMONWEALTH OF MASSACHUSETTS,

Respondent.

On Petition For Writ Of Certiorari
To The Supreme Judicial Court Of Massachusetts

SUPPLEMENTAL BRIEF OF PETITIONERS IN REPLY TO THE BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

MARK A. MICHELSON
CHOATE, HALL & STEWART
Exchange Place
53 State Street
Boston, MA 02109
(617) 227-5020
Counsel of Record
for Petitioners

Of Counsel:

CHARLES FRIED
Langdell Hall Lw228
1545 Massachusetts Avenue
Cambridge, MA 02138

SAMUEL B. BRUSKIN
ROBERT M. BUCHANAN, JR.
CHOATE, HALL & STEWART
Exchange Place
53 State Street
Boston, MA 02109

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Petitioners Liberty Mutual Insurance Company and Liberty Mutual Fire Insurance Company (jointly, "Liberty Mutual") submit this Supplemental Brief pursuant to Rule 22.6. This Supplemental Brief replies to the Brief for the United States As Amicus Curiae ("U.S. Brief"), which was filed March 2, 1990, and supports Liberty Mutual's Petition for Writ of Certiorari ("Petition"), which was filed October 9, 1989. It is respectfully submitted that the U.S. Brief largely ignores the clear intent of Congress and the express language of the governing federal statute, and addresses the merits of the case rather than the appropriateness of granting certiorari.

INTRODUCTION

In our petition for certiorari we argued that Mass. G.L. c. 63, § 22A, is in direct violation of 31 U.S.C. § 742. That provision exempts all obligations of the United States from "every form" of state taxation, "direct or indirect." The Massachusetts law, by including the interest on federal obligations in the tax it levies on domestic insurance companies,[1] violates the federal statute. The purpose of the federal statute, and its violation here by the state statute, would be quite clear but for the exception in 31 U.S.C. § 742 allowing states to impose "nondiscriminatory franchise . . . taxes . . . ."

Our contention is simply that this exception must leave some independent force to the requirement that the permitted tax be in reality a franchise tax, and that whether the state has properly given effect to this limitation on its taxing power presents a substantial federal question not likely to be fairly considered other than by periodic review by this Court. The Solicitor General, we respectfully suggest, has largely missed the point of our submission.

The Solicitor General recounts the progressive disenchantment of this Court with the constitutional doctrine of intergovernmental tax immunity, a story having its denouement in this Court's decision in *South Carolina v. Baker*, 485

[1] Indeed in the usual case under this statute bond interest will be the principal item so taxed.

U.S. 505 (1988). But that story has nothing to do with this case. The immunity which petitioners urge, and on which they and other investors relied in purchasing United States obligations, is one mandated by Congress and reenacted, broadened and clarified as recently as 1959. It is not some archaic constitutional doctrine which we seek to resurrect. Rather, we ask fidelity to the expressed and recent will of Congress.

The Solicitor General joins the Commonwealth in asserting as a principal basis for calling this a true "franchise" tax (a tax on the privilege of doing business) the doubtful proposition that this tax is not levied in any year in which the company is not doing business. But unless the protection of the statute is to be rendered a nullity by a mere affixing of labels by the state courts, more than this must be shown. In effect both the Commonwealth and the Solicitor General read the term "franchise" out of the statute, leaving only the requirement that the tax on United States obligations be nondiscriminatory. Perhaps such a recasting would accord with what the Solicitor General considers more modern principles of intergovernmental tax relations. It is certainly not faithful to the command of Congress.

Like the thirteenth chime of the clock, the Solicitor General's reference to this Court's decision in *Provident Institution v. Massachusetts*, 73 U.S. (6 Wall.) 611 (1868), betrays the basically dismissive attitude of the U.S. Brief to the substantial issues raised here. The Solicitor General argues (U.S. Brief at 7) that the tax upheld in *Provident* was a franchise tax and "the origin of the present excise tax on domestic insurance companies. . . ." The characterization is inaccurate and the analogy non-existent. *Provident* involved a tax on the deposits of savings institutions and reached the perfectly sensible conclusion that the bank could not escape a part of such a tax by investing some of those deposits in federal obligations. There is no connection and no analogy with the gross investment income tax adopted in 1971.

Finally, the Solicitor General urges denial of the writ on the ground that there is no conflict in the decisions, but does not advert to our argument that these cases can only originate in state courts and come to a federal court for review by way of certiorari, and that it is not likely that any state court will take any but the most grudging view of its duties to recognize exemptions from taxation under the Congressional mandate. Thus, it is important for this Court to construe the exemption in question and give it some meaning.

A. Whether A State Tax Qualifies As A "Franchise" Tax Within The Meaning Of 31 U.S.C. § 742 Is A Federal Question.

This case turns on the construction of a federal statute enacted in order to protect federal bonds from state taxation.[2] Congress has provided that the income from federal bonds is exempt from state taxes, except in the case of a non-discriminatory "franchise" tax. This Petition presents the important question of what constitutes a "franchise" tax within the meaning of the statute. This is necessarily a federal question.

B. Section 742 Must Be Construed So As To Give Some Content To The Statutory Phrase "Franchise" Tax.

Congress must have meant the term "franchise" tax to have some realistic meaning when it used the term in 31 U.S.C. § 742, or else Congress would have permitted *any* non-discriminatory non-property tax to be imposed on a corporation. The very purpose of the 1959 amendment to Section 742 was to reduce the scope of permissible state taxes. *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983). To allow the states to call any tax a franchise tax in order to save it, as the Supreme Judicial Court did here, is to allow the statutory exception to swallow the statutory rule.

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[2] Petitioners will continue to refer to the statute at issue as 31 U.S.C. § 742, as it stood during the years in question. The statute has now been recodified without substantive change as 31 U.S.C. § 3124(a).

This franchise exception can be kept within appropriate limits by confining it to its normal and accepted meaning. A "franchise" tax is one that reasonably attempts to measure the value of the franchise. Various formulas such as net worth, the value of assets, the market value of a company's stock, net income, or allocated net value of insurance in force, might reasonably be employed to approximate the value of a franchise.

The U.S. Brief maintains that Section 22A is a "franchise" tax because a Massachusetts insurance company is no longer subject to the tax once it ceases doing business in the Commonwealth. U.S. Brief at 8-9.[3] This is a necessary condition for qualifying as a "franchise" tax, but it is hardly sufficient, especially since a domestic company that ceases doing business is not likely to have much income or other benefit from its unexercised franchise anyway. On the argument of the United States the way the tax is measured would be wholly irrelevant, and a non-discriminatory tax of any kind could qualify as a "franchise" tax so long as it was labelled a tax imposed on the privilege of doing business.

The U.S. Brief entirely misses the significance of Congress' amendment of 31 U.S.C. § 742 in 1959. Congress acted in order to reject the very argument the Solicitor General now makes, as this Court explained in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 865-67 (1983). Idaho had asserted that its personal income tax could include interest on United States Government Bonds because the tax was not "on" income but rather was "on" individuals and merely "measured by" income. Congress rejected that position by providing that the exemption for United States Government Bonds "extends to *every* form of taxation that would

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[3] The U.S. Brief at 8-9 fails to reflect the fact that the Massachusetts legislature soon overruled *Commissioner of Ins. v. Commonwealth Mutual Liability Ins. Co.*, 308 Mass. 385, 32 N.E.2d 231 (1941). *See* St. 1945, c. 342, amending General Laws, c. 63, § 28.

require that either the obligations or the interest thereon, or both, be *considered, directly or indirectly*, in the computation of the tax. . . ." *See American Bank*, 463 U.S. at 867 (emphasis added).

Congress thus rejected the distinction, which is a necessary underpinning of the asserted validity of the Massachusetts tax, between a tax "on" income and a tax "measured by" income. To be sure, as the U.S. Brief says at 7-8, a *1955* decision of this Court found the distinction "firmly embedded in [judge-made] law". *Society for Savings v. Bowers*, 349 U.S. 143, 148 (1955). Far from perpetuating that distinction, however, Congress in *1959* "rejected and set aside" the Court's earlier "formalistic approach" in order to broaden the statutory prohibition. *American Bank*, 463 U.S. at 862-65.

Contrary to the Solicitor General's premise, this Petition does not ask the Court to revive the doctrine of implied intergovernmental immunity. Because Congress took express action in 1959 to define the position of the federal government – and to reject the then-prevailing view of this Court – the case is not about *implied* immunity at all.[4] Rather, Petitioners ask the Court to provide an authoritative construction of an important Act of Congress which otherwise the states have been and are free to ignore or distort.

C. The Tax At Issue Is Not A "Franchise" Tax, Because It Bears No Reasonable Relation To The Value Of The Franchise.

Since the term "franchise" tax must have some reasonable meaning, some lines must be drawn to effectuate the Congressional intent to limit the state taxes that qualify, although Congress no doubt intended to leave the states considerable latitude in determining the parameters of a permissible franchise tax. This Court established one necessary

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[4] For this reason, the U.S. Brief's citations at 10-11 to *South Carolina v. Baker*, 485 U.S. 505 (1988), and *United States v. New Mexico*, 455 U.S. 720 (1982), are not on point.

limit in *Northwestern Mutual Ins. Co. v. Wisconsin*, 275 U.S. 136 (1927). *Northwestern Mutual* held squarely that a *gross* income tax may not reach the interest on United States Government Bonds. The Court reasoned that a gross income tax measures nothing but the income from the bonds; thus it cannot be said that such a tax is imposed "on" anything else. The Court distinguished a net income tax, which takes into account expenses and other factors and bears a direct relation to value. As demonstrated in the Petition at 12-13, this Court has *never* allowed a tax measured by *gross* income to reach federal bond interest. The cases cited by the United States concern net income, net worth or the value of assets, all of which are traditional measures of franchise taxes. *Compare* Petition at 12-13 *with* U.S. Brief at 7.[5]

The tax at issue is measured by 1% of a Massachusetts insurance company's gross investment income. Gross income, however, cannot measure the value of a franchise. A taxpayer which is losing and is likely to continue to lose substantial amounts of money – and thus has a currently valueless franchise – is still required to pay a tax, possibly quite large. Two taxpayers holding equally valuable franchises may well pay very different amounts of tax. An insurer with large policy losses would be required to pay as large a gross investment income tax as an insurer with the same gross investment income but large policy surpluses.

Section 22A thus makes no attempt to measure the value of any franchise. It requires a domestic insurance company to pay 1% of the "gross investment income" it reports on its Annual Statement to the state Insurance Commissioner, regardless of every other fact of the insurer's financial condition, so long as it has not surrendered its license (or even if it

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[5] The United States cites two cases for the proposition that a gross income tax may be a franchise tax. U.S. Brief at 10, *citing General Motors Corp. v. Washington*, 377 U.S. 436 (1964); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). Neither of these cases construed 31 U.S.C. § 742 at all. Both cases considered constitutional challenges only. The Court had no occasion to consider whether the tax at issue was a "franchise" tax as Congress used that term in Section 742.

has, see n. 3, *supra*). The Annual Statement was never intended to determine the value of the franchise. (It existed before Section 22A was enacted, and was picked as the basis of the tax for reasons of convenience.) The regulatory purpose of the Annual Statement is to disclose on a consistent basis[6] the financial strength of the state's insurance companies, so that a consumer, *i.e.*, a prospective buyer of a policy, not of stock in the insurer, may make an informed choice. *See* Brief in Opposition at 7. Thus the tax imposed by Section 22A is completely arbitrary in its relation to the value of each insurer's franchise. It cannot fairly be said to be imposed on the privilege of doing business and measured by the value of that privilege, even very roughly.

Long before Section 22A was enacted Massachusetts had, and still has, insurance company excise taxes based on premiums, G.L. c. 63, §§ 20, 22, and (for life insurance companies, in some circumstances) on net value of policies, St. 1943, c. 531. *See State Tax Comm'n v. John Hancock Mutual Life Ins. Co.*, 341 Mass. 555, 170 N.E.2d 711 (1960). In contrast, Section 22A was not an attempt to tax the value of the privilege of doing business, but merely to identify and tax an item of revenue that had not previously been taxed. It is an exercise in arbitrary labelling to call this tax a "franchise" tax in order to save it, when its scope and effect resulted merely from the legislature's realization that it could reach a convenient item that had hitherto escaped taxation.

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[6] It is for the sake of this consistency that the Annual Statement shows figures for imputed home office rent, to facilitate comparisons between companies that own and companies that rent their home offices. Like amortization of federal tax credits and earnings on assets earmarked for employees' and agents' pension plans, which also appear on the Annual Statement and are swept up into the tax imposed by Section 22A, these items bear no relation whatsoever to the value of the franchise.

D. The United States Is In Error Concerning The Origin Of The Massachusetts Tax At Issue.

The Solicitor General erroneously states that the predecessor of Section 22A was found to be a franchise tax in *Provident Institution v. Massachusetts*, 73 U.S. (6 Wall.) 611 (1868). U.S. Brief at 8. In fact, Section 22A was enacted for the first time in 1971, and it had no predecessor. *See* Brief in Opposition at 6; Mass. St. 1971, c. 555, § 27. The tax in *Provident* was levied on savings banks and was measured by their deposits. Section 22A, which taxes gross investment income, is an entirely different tax.

The United States' citation to *Provident* is even further afield. The bank in *Provident* argued that its deposits should be immune from taxation to the extent that they were invested in federal bonds. The Court rejected that argument, for the obvious reason that the tax was imposed on the deposits, *i.e.*, liabilities, not the bonds, *i.e.*, assets. In the parlance of the current federal statute, the tax in *Provident* did not even indirectly consider federal bonds in the computation of the tax. The issue here, where the tax is computed by measuring the income from federal bonds and other investments, is vastly different. The contention of the United States that the *Provident* case provides guidance or authority in the present situation is indicative of the Solicitor General's basically dismissive approach to the questions before the Court.

E. The United States Does Not Address The Importance Of The Questions Presented By This Petition.

Cases which challenge the application of state taxes to United States Government Bonds arise exclusively in the state courts. *See* 28 U.S.C. § 1341. The federal interest in exempting United States Government Bonds understandably appears distant to these courts, while the state interest in preserving tax revenues is immediate. Thus state courts have generally upheld state taxes in cases such as this, and have not been sensitive to the intent of Congress. This strong tendency explains why there are few conflicting decisions in the state courts. The conflict here is not among the states so much as it

is between the states on one side and the federal legislation on the other.[7] The Supreme Court is the only court able to declare authoritatively what Congress meant when it created the "franchise tax" exception to § 742.

Liberty Mutual's Petition presents an important question of statutory interpretation. The answer is likely to affect many millions of dollars of interest expense to the United States Treasury. Even if the Solicitor General is not interested in these financial implications for the federal fisc, the expectations of investors who purchased United States Government Bonds in reliance on this explicit statutory exemption are entitled to the protection Congress intends to give them. Congress has expressly acted to protect federal obligations from state taxation, thereby reducing the interest expense to the United States Treasury. The Massachusetts decision below, like other state decisions, is inconsistent with the express purpose of that legislation. The aid of the Supreme Court is required to declare and to enforce the will of Congress in protecting the federal fisc, and in any event to clarify the rules which the states must follow, whether or not the Court ultimately adopts the position Liberty Mutual asserts.

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[7] It is not clear, however, why the United States discounts *Federal Products Corp. v. Norberg*, 429 A.2d 447 (R.I. 1981). U.S. Brief at 12. To be sure, the court in that case ruled that the tax at issue was not a franchise tax, because it was enacted under the heading "Income Tax", while a separate provision carried the heading "Franchise Tax". To rely solely on this distinction, however, would be to resort to mere labelling.

CONCLUSION

The questions presented are important and unsettled. They are clearly presented by this case. The petition for certiorari should be granted.

Respectfully submitted,

Liberty Mutual Insurance Company
Liberty Mutual Fire Insurance Company

By their attorneys,

MARK A. MICHELSON
CHOATE, HALL & STEWART
Exchange Place
53 State Street
Boston, MA 02109
(617) 227-5020

Of Counsel:

CHARLES FRIED
Langdell Hall Lw228
1545 Massachusetts Avenue
Cambridge, MA 02138

SAMUEL B. BRUSKIN
ROBERT M. BUCHANAN, JR.
CHOATE, HALL & STEWART
Exchange Place
53 State Street
Boston, MA 02109

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